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Venture Capital Financings

March 2021

Agenda

- ***Financing Process***
- ***General Financing Terms***
- ***Board of Directors***

General Financing Steps

- ***Deal Origination***
- ***Evaluation / Business Due Diligence***
- ***Term Sheet / Deal Structure***
  - Convertible notes / SAFEs / KISSs
  - Equity Financing
- ***Deal Execution***
  - Legal due diligence
  - Documentation (commonly use the NVCA forms)
  - Additional investor outreach
- ***Closing***

What is a term sheet?

- A **non-binding** document that lays out the proposed terms of the financing and minimizes negotiations of the main documents
- It serves as a roadmap of your future economic and voting relationship with your investor(s)

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Deciding between Convertible or Equity round

Pros of Convertible financings

- No need to establish valuation
- Usually simpler and less paperwork
- Founders have more control
- Avoid giving stockholders rights and vetoes or board seats to lenders prior to conversion

Cons of Debt financings

- Dilution to founders is not defined
- May requires repayment, no matter how well or poorly the company is doing

Pros of Equity financings

- Generally larger amounts of money being raised
- No fixed repayments other than in connection with a liquidity event
- Dilution is defined

Cons of Equity financings

- Founders more likely giving up decision making control via board seats and protective provisions
- Usually more paperwork and more expensive

Convertible Promissory Note Term Sheet – Key Negotiating Terms

Advantage (or disadvantage) of a note is that the stock price is not set and is determined at a later financing

Maturity date: Generally 12-24 months from the date of issuance of the note

Discount: 10% to 30% range (20% common) on the price paid by an investor on a next equity round financing

Valuation Cap: Investor friendly term that places a ceiling on a conversion price of the debt (companies want to avoid setting a "cap")

Interest Rate: Between 4% and 12% (6-8% common) - may not be lower than AFR*

Conversion mechanics: Converts automatically upon a qualified financing; may have a conversion feature upon a non-qualified financing. Usually change of control triggers option of holder to be repaid or convert. Default triggers repayment.

*applicable Federal rates

Simple Agreement for Future Equity (SAFE)

- SAFEs are not debt
- No interest rate or maturity date
- Pre-money capitalization version
- Post-money capitalization version

Four main terms to negotiate:

Discounts

Valuation caps

Most Favored Nation clause (MFN)
- If better terms are given to future investors, those more favorable terms are provided to the SAFE investors as well

Pro rata rights
- Investors have the right to participate in a subsequent financing round to maintain their level of percentage ownership in the company

Equity Term Sheet Blueprint

Offering Terms

- Closing Date
- Investors
- Amount Raised
- PPS/Pre-Money Valuation
- Capitalization

Charter

- Dividends
- Liquidation
- Voting Rights
- Protective Provisions
- Optional Conversion
- Anti-dilution
- Mandatory Conversion

Stock Purchase Agreement

- Representations and Warranties
- Conditions to Closing
- Counsel and Expenses

Investors' Rights Agreement

- Registration Rights
- Management & Information Rights
- Preemptive Rights
- Investor Director Approval
- Non-Competes/Solicits & NDAs
- Board Matters
- Employee Stock Options
- Key Person Insurance

Right of First Refusal/Co-Sale Agreement

- Right of First Refusal
- Right of Co-Sale (Tag Along)

Voting Agreement

- Board of Directors
- Drag Along/Sale Rights

Other

- Founders' Stock
- No Shop/Confidentiality

Valuation: price per share, pre-money vs. post-money

- The “pre-money valuation” is the investor’s current valuation of the company, before the investment

- The “post-money” valuation = the pre-money valuation + the amount of money raised in the round

- The price per share (PPS) that an investor will pay for shares = pre-money valuation

  fully diluted capitalization

- Fully diluted capitalization generally includes all issued and outstanding shares <u>plus</u> shares of Common Stock reserved for issuance under an Equity Incentive Plan and all shares of stock in which outstanding convertible securities will convert into

Pre-Money Valuation:	The Original Purchase Price is based upon a fully-diluted pre-money valuation of $[______] and a fully-diluted post-money valuation of $[_______] (including an employee pool representing [___]% of the fully-diluted post-money capitalization).

Economic Rights

Liquidation Preference

- Liquidity Event generally means a sale of all or substantially all of the assets of the Company and a merger, reorganization or other transaction in which 50% of the outstanding voting power of the Company is transferred

- Liquidation Preference means that proceeds from a liquidity event are first distributed to Investors typically at a 1x – 2x multiple (i.e. the investor receives a multiple of the price per share originally paid by such investor)

- Non-participating: Investor receives the Liquidation Preference and the remainder of proceeds are distributed to the holders of Common Stock on a pro-rata basis; or

- Participating: Investor receives the Liquidation Preference and the remainder proceeds are distributed amongst all stockholders of the company an as-converted basis (as if all stock converted into Common Stock based on the conversion ratio)

Dividends

Typically:

- "Annual $_____ per share [___%] dividend on the Series ____ Preferred Stock, payable <u>when and if declared by Board</u>, and prior and in preference to any declaration or payment of other dividends; dividends <u>are not cumulative</u>. For any other dividends or similar distributions, <u>Preferred Stock participates with Common Stock on an as-converted basis</u>."

- 6% – 8% of the price per share originally paid by the Investor is standard

- Venture backed companies do not typically pay dividends. In some cases, investors try to negotiate a dividend that is cumulative, which means that it accrues from year to year until it is paid. Cumulative dividends are not standard

Governance Rights

Protective Provisions

Protective provisions are those matters of which approval require the approval of a certain percentage of Preferred Stock voting as a separate class, including, but not limited to:

- Authorize or issue securities that rank senior to or in parity with the latest series of Preferred Stock (i.e. raising a convertible debt or equity round)
- Increase or decrease the number of authorized Common or Preferred Stock
- Increase or decrease the size of the Board of Directors
- Consummate a Liquidation Event

Essentially it consists of a veto right investors have on certain actions by the company

Consider:

- Decision to vote as a single class (i.e. single vote for all investors) or multiple classes (i.e., later series investors would not have a separate vote for their respective protective provisions)
- Requisite consent percentage should not be too high

- Company should avoid giving veto to an specific investor or series by series vetoes
- Place a minimum threshold of outstanding shares of Preferred Stock in order for the protective provisions to remain in place

Conversion of Preferred Stock into Common Stock

- Preferred Stock is initially be convertible into one share of Common Stock (subject to antidilution adjustment) at any time at the holder's option (conversion rate is usually 1:1)

- Preferred Stock automatically converts into Common Stock upon (i) the election of [__%] of the outstanding shares of Preferred Stock or (ii) the consummation of an underwritten public offering with [a price per share of $[often 3-5x cost] and] aggregate proceeds in excess of [$20,000,000]

Antidilution Rights

- Protects Investors from dilution in the event the Company issues stock at a lower price per share (e.g. down-round) by adjusting the conversion rate (exceptions apply)

- Typically, conversion ratio for Preferred Stock is adjusted on a **broad-weighted average basis** in such event. The broad-based weighted average formula results in a smaller antidilution adjustment than narrow weighted average, because it takes into account unexercised options and outstanding convertible notes and warrants.

  <u>Variations include</u>:

  (1) "full ratchet" antidilution which results in the largest antidilution adjustment by adjusting the purchase price of the stock to the price of the shares issued in the later round, and is rarely used. on after their investment;

  (1) "pay-to-play" (i) mild which requires investors to purchase their full pro-rata share of any subsequent down-rounds of financing in order to receive the benefit of price-based antidilution in current or future rounds; or (ii) aggressive which results in the conversion of Preferred Stock to Common Stock and the loss of contractual rights with respect to the Preferred Stock. "Pay to play" provisions are not commonly used.

Registration Rights

- Provides for typical registration rights and are not very important at an early stage company (demand rights, piggyback rights, S-3 rights)
- Some investors agree not to include those in the Company's documents until the following financing round

Information Rights

- Investors [holding at least [x] shares of Preferred Stock] shall have the right to receive standard information rights including audited financial reports within 90 days after the end of the fiscal year, quarterly unaudited financial reports within 45 days after the end of each of the first three quarters, [monthly unaudited financial reports within 30 days after the end of the month] and annual budget and business plan 30 days prior to the beginning of a fiscal year, as well as standard inspection rights

Preemptive Rights/Pro-Rata Rights

- Preemptive Rights, Rights of First Offer or Pro-Rata Right is the right, but not an obligation, given to Investors [holding at least [x] shares of Preferred Stock] to participate in subsequent financings of the Company on a pro-rata basis, based on their percentage equity ownership of the Company on a fully-diluted basis

ROFR and Co-Sale Rights

Transfers of Common stock by Founders are restricted

- No transfers allowed prior to vesting, except for certain estate planning transfers

- Typically until a public offering (initial offering or qualified offering) or control of the Company is transferred, each Investor [holding at least [x] shares of Preferred Stock] shall have the right to participate on a pro rata basis in transfers of any stock held by the Founders (co-sale right); and a right of first refusal on such transfers, subordinate to the Company's right of first refusal

Drag-Along Rights

- Drag-along provisions are generally used where a corporate investor purchases a Company's stock. Given that corporate investors may vote their shares in the Company based on competitive considerations (e.g., Strategic Investor that produces toys in Asia doesn't want a N.A. Toys, a North America toys company to purchase the Company, a start-up that has launched a successful games app that may help N.A. Toys' competitive position), companies often require such strategic corporate investors to vote their shares in the same manner as the traditional venture capital investors

- In the event of a proposed sale of the Company (whether pursuant to a merger, stock sale or similar transaction) to a third party that is approved by:
    - a [majority] of the Preferred Stock;
    - [a majority of the Common Stock]; and
    - [the Board of Directors]

all remaining stockholders of the Company must vote to approve such sale and may be required to transfer the same percentage of securities on the same terms and conditions

Introduction to the Board of Directors

Objectives, Timing of Creation, Number of Directors, Number of Meetings and Compensation

Objectives and Timing

A Board must be put in place when the Company is incorporated

- The Board holds ultimate responsibility for the business and affairs of the Company, and acts as the agent of the stockholders
- Company must have a Board to handle major corporate matters like issuing stock, authorizing a merger, setting up a stock option plan, authorizing a fundraising or getting loans

Number of Directors

Company may have only one Board member, and it may be the founder

After the initial seed round, a Company usually allocates a Board seat to the firm or person who led that seed round

- A fairly typical setup at this stage would be for the common stockholders (i.e. the founders) to retain two Board seats and the new investor to have one seat
- It is common to allocate a new Board seat for the lead investor for each new round of investment

Introduction to the Board of Directors

Number of Directors (continued)

After the second round of financing, it is fairly common to also designate one seat as an “independent” seat

- An independent is not an investor or a founder or an employee of the Company
- By appointing an independent after the second round, the composition of the Board would be the two founders, the two investors and the independent - many companies choose to have an odd number of directors to reduce the risk of a tie vote

Number of Meetings

How often a Board meets depends on the stage of the Company, the needs of management and other factors

- Typically a startup Board meets in person once a quarter, toward the beginning of the quarter to review the prior quarter’s results
- Early-stage companies might also hold more frequent informal Board meetings, either in person or by phone
- Number of meetings may increase during intense times, such as crisis situations or when the Company is being acquired or is acquiring another company, possibly meeting every day or multiple times per day

Board Members, Board Observers and Board Advisers

Board Members vs Board Observers vs Board Advisers

Directors

- Founders want to maintain voting control of their Board for as long as possible
- Board composition should reflect Company's stage of development and needs
- Want to keep Board limited in size early on
- Having an investor on a Company's Board can serve as a credential for the Company

Observers

- Investor may also request to have a Board observer
- Observers don't vote, but they are entitled to receive access to materials and Board discussions
- If a second-largest investor has a large stake, you might want to give them a Board observer seat

Board Members, Board Observers and Board Advisers

Advisers

- Advisers are individuals with business experience or other relevant expertise who advise the Company on management and strategy issues which may include:
  - Specific talents, skill sets and experience
  - Knowledge
  - Lending credibility and facilitating business connections
  - E.g., many biotech companies have scientific advisory boards composed of scientists, researchers in the industry, former founders, or industry executives
- Board advisers have no authority to make business decisions or manage Company affairs
- Advisers generally serve at the pleasure of the Board or management

Competitive information and/or information subject to attorney-client privilege may be withheld from Board observers and Board advisers

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